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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman  
GARY PIERCE  
PAUL NEWMAN  
SANDRA D. KENNEDY  
BOB STUMP

IN THE MATTER OF THE APPLICATION  
OF JOHNSON UTILITIES, LLC, DBA  
JOHNSON UTILITIES COMPANY FOR AN  
INCREASE IN ITS WATER AND  
WASTEWATER RATES FOR CUSTOMERS  
WITHIN PINAL COUNTY, ARIZONA.

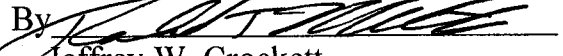
DOCKET NO. WS-02987A-08-0180

**JOHNSON UTILITIES, LLC'S  
NOTICE OF FILING  
REJOINDER TESTIMONIES**

Johnson Utilities, LLC, dba Johnson Utilities, through counsel undersigned,  
hereby files the rejoinder testimony for Thomas J. Bourassa, Volume I - Cost of Capital  
in the above-captioned matter.


RESPECTFULLY SUBMITTED this 17th day of April, 2009.

SNELL & WILMER L.L.P.

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Arizona Corporation Commission  
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1                   **BEFORE THE ARIZONA CORPORATION COMMISSION**

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3                   COMMISSIONERS

4                   KRISTIN K. MAYES—Chairman  
5                   GARY PIERCE  
6                   PAUL NEWMAN  
7                   SANDRA D. KENNEDY  
8                   BOB STUMP

9                   IN THE MATTER OF THE APPLICATION  
10                  OF JOHNSON UTILITIES, L.L.C., DBA  
11                  JOHNSON UTILITIES COMPANY FOR AN  
12                  INCREASE IN ITS WATER AND  
13                  WASTEWATER RATES FOR CUSTOMERS  
14                  WITHIN PINAL COUNTY, ARIZONA.

DOCKET NO. WS-02987A-08-0180

15                   **PRE-FILED REJOINDER TESTIMONY OF THOMAS J. BOURASSA**  
16                   **ON BEHALF OF**  
17                   **JOHNSON UTILITIES L.L.C., DBA JOHNSON UTILITIES COMPANY**  
18                   **(VOLUME I – COST OF CAPITAL)**

19                   **April 16, 2009**  
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1 **I. INTRODUCTION AND QUALIFICATIONS**

2  
3 **Q. PLEASE STATE YOUR NAME AND ADDRESS.**

4 A. My name is Thomas J. Bourassa. My business address is 139 W. Wood Drive,  
5 Phoenix, Arizona 85029.  
6

7 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS CASE?**

8 A. On behalf of the applicant, Johnson Utilities L.L.C., dba Jonson Utilities Company  
9 ("Johnson Utilities" or the "Company").  
10

11 **Q. ARE YOU THE SAME THOMAS J. BOURASSA THAT PRE-FILED**  
12 **DIRECT AND REBUTTAL TESTIMONY ON THE COST OF CAPITAL,**  
13 **INCLUDING THE COST OF EQUITY, ON BEHALF OF THE COMPANY**  
14 **IN THIS CASE?**  
15

16 A. Yes I am.  
17

18 **Q. DID YOU ALSO PRE-FILED DIRECT, REBUTTAL AND REJOINDER**  
19 **TESTIMONY ON THE WATER AND WASTEWATER DIVISION RATE**  
20 **BASES, INCOME STATEMENTS, REVENUE REQUIREMENTS AND**  
21 **RATE DESIGNS IN THIS CASE?**

22 A. Yes.  
23

24 **Q. WHAT IS THE PURPOSE OF YOUR REJOINDER TESTIMONY SET**  
25 **FORTH IN THIS VOLUME I?**  
26

1 A. The purpose of this rejoinder testimony is to respond as appropriate to the  
2 surrebuttal testimony of Mr. Jeffery M. Michlik on behalf of the Utilities Division  
3 ("Staff") of the Arizona Corporation Commission ("Commission"), and the  
4 surrebuttal testimony of Mr. William A. Rigsby on behalf of the Residential  
5 Utility Consumer Office ("RUCO").<sup>1</sup>  
6

7 **II. SUMMARY OF REJOINDER TESTIMONY**  
8

9 **Q. PLEASE SUMMARIZE YOUR RECOMMENDED COST OF DEBT AND**  
10 **EQUITY, AND YOUR RECOMMENDED RATE OF RETURN ON RATE**  
11 **BASE AT THIS STAGE OF THE PROCEEDINGS.**

12 A. The Company's recommended capital structure consists of 2.8 percent debt and  
13 97.2 percent common equity. I am recommending a cost of equity of 12.0 percent  
14 for the Company based on my cost of capital update set forth in my rebuttal  
15 testimony. The Company's recommended cost of debt is 8.0 percent.

16  
17 Based on my 12.0 percent recommended cost of equity, the Company's weighted  
18 average cost of capital ("WACC") is 11.89 percent. I recommend that the WACC  
19 be used as the rate of return and applied to the Company's fair value rate base  
20 ("FVRB") to compute the Company's required operating income.  
21

22 **Q. PLEASE SUMMARIZE THE COST OF DEBT AND EQUITY**  
23 **RECOMMENDED BY STAFF AND RUCO, AND THEIR RESPECTIVE**  
24

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25 <sup>1</sup> My rejoinder testimony relating to the Company's water and wastewater Division rate bases, income statements (revenue and operating expenses), required increases in revenue, and rate designs and proposed rates and charges for services are set forth in Volumes II and II, respectively.

1       **RECOMMENDATIONS FOR THE RATE OF RETURN ON FAIR VALUE**  
2       **RATE BASE.**

3   A.   Staff is recommending an operating margin approach. Staff recommends a 10  
4       percent operating margin.<sup>2</sup> This is because Staff is recommending negative rate  
5       bases for both the water and wastewater divisions. A 10 percent operating margin  
6       is considered the minimum operating margin employed when rate base is negative  
7       and has been adopted by this Commission in the past (*e.g. Valley Utilities Water*  
8       *Company*, Decision 68309, November 14, 2005). Because Staff is recommending  
9       an operating margin approach it has not provided a cost of capital analysis nor has  
10      it directly responded to my rebuttal testimony on cost of capital.

11  
12      On the other hand, RUCO has recommended a cost of equity of 8.31 percent,  
13      based on the average cost of equity of its DCF and CAPM results.<sup>3</sup> RUCO's  
14      recommended cost of debt is 8.0 percent, based on the Company's existing debt  
15      cost.<sup>4</sup> RUCO is proposing a hypothetical capital structure of 40 percent debt and  
16      60 percent equity. Based on a hypothetical capital structure of 40 percent debt  
17      and 60 percent equity, RUCO computed a WACC of 8.18 percent, which is  
18      RUCO's recommended rate of return on FVRB.<sup>5</sup>

19  
20   **III.   THE COMPANY'S RESPONSE TO RUCO'S SURREBUTTAL**  
21       **TESTIMONY**

22  
23  
24   <sup>2</sup> See Direct Testimony of Jeffrey M. Michlik at 29 and 31 for Wastewater and Water Division, respectively.

25   <sup>3</sup> See Surrebuttal Testimony of William A. Rigsby ("Rigsby Rbt") at 4.

<sup>4</sup> *Id.* at 5.

<sup>5</sup> *Id.* at 3.



1       A.     **Low Interest Rates and the Market Risk Premium**

2     **Q.     DO THE RECENT LOW INTEREST RATES NECESSARILY MEAN**  
3       **THAT COSTS OF EQUITY ARE LOWER?**

4     A.     No. Mr. Rigsby makes this argument. However, while financial theory suggests  
5       that the cost of equity generally moves in the direction of interest rates, it does not  
6       necessarily move in lock step with interest rates. When the market risk premium  
7       ("MRP") increases it can offset decreases in interest rates. If the MRP premium  
8       increases, decreases to in interest rates can be offset and visa versa. Substantial  
9       increases in the MRP can actually offset the interest rate decreases resulting in an  
10      overall increase in the cost of equity.

11           In the past I have testified that Staff's CAPM approach to estimating the  
12      cost of capital were producing results that were inconsistent with financial theory.  
13      In the Far West Water and Sewer Company Case (Decision 69335, February 20,  
14      2007), for example, I argued that when both beta and interest rates were rising,  
15      Staff's CAPM estimates were either going down or remaining the same. The  
16      Commission rejected my arguments stating that I ignored change to the MRP that  
17      is recognized by Staff's approach.<sup>6</sup> Others, including Dr. Thomas M. Zepp have  
18      made similar arguments, but those arguments have also been rejected by this  
19      Commission.<sup>7</sup> Staff's cost of equity using the current MRP CAPM approach has  
20      been repeatedly adopted by this Commission in the past (e.g. *Chaparral City*  
21      *Water Company*, Decision 68176, September 30, 2005, *Arizona Water Company –*  
22      *Western Group*, Decision 68302, November 14, 2005, *Goodman Water Company*,  
23      Decision 69404, April 16, 2007, *Far West Water and Sewer Company*, Decision

24  
25       

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<sup>6</sup> See Far West Water and Sewer Company, Decision 69335, February 20, 2007, at 18.

<sup>7</sup> See Arizona Water Company – Western Group, Decision 68302, November 14, 2005, at 38.

1 69335, February 20, 2007, *Black Mountain Sewer Company*, Decision 69164,  
2 December 5, 1005).

3  
4 **Q. DOES YOUR CAPM APPROACH UTILIZE A CURRENT MARKET RISK**  
5 **PREMIUM ESTIMATE?**

6 A. Yes. Since the Far West Water and Sewer case, I have used a current MRP  
7 CAPM approach in my cost of capital analysis that is the same as that which was  
8 used by Staff in the past. Arguably, I use a more conservative and more stable  
9 method of computing the current market return which is then used to estimate the  
10 current MRP, but the method is the same.

11  
12 **Q. DOES MR. RISGBY'S CAPM APPROACH ADDRESS THE CURRENT**  
13 **MARKET RISK PREMIUM IN ANY WAY?**

14 A. No. He uses historical 80 year geometric and arithmetic means as estimates of the  
15 MRP. Thus, his CAPM approach fails to consider the current economic and  
16 financial conditions which are impacting the current cost of equity.

17  
18 **Q. HAVE INTEREST RATES DECREASED SINCE YOU PREPARED YOUR**  
19 **COST OF CAPITAL UPDATE IN DECEMBER 2008?**

20 A. No. I prepared my rebuttal cost of capital update based on data from mid-  
21 December 2008. At that time the average of the 5, 7, and 10 year U.S. Treasuries  
22 was 2.34 percent and the 30 year U.S. Treasury was 3.68 percent. Based on the  
23 Federal Reserve data on April 9, 2009, the average of the 5, 7, and 10 year U.S.  
24 Treasuries was 2.45 percent and the 30 year U.S. Treasury was 3.76 percent.  
25

1  
2 **Q. HAS THE CURRENT MARKET RISK PREMIUM CHANGED**  
3 **SIGNIFCANTLY SINCE YOU PREPARED YOUR COST OF CAPITAL**  
4 **UPDATE IN DECEMBER 2008?**

5  
6 A. No. In fact, it is at least as great as, if not greater than, the current MRP I  
7 estimated in mid-December 2008.

8  
9 **Q. SO THE COST OF EQUITY HAS REMAINED HIGH?**

10 A. Yes. This is not surprising. There continues to be significant uncertainty in the  
11 capital markets over the future economic and financial conditions in the coming  
12 years. This is risk to investors and investors are reluctant to invest in equity  
13 securities without a commensurate return that reflects their expected investment  
14 risk.  
15

16  
17 **Q. DID YOUR ESTIMATE OF THE MARKET RISK PREMIUM INCREASE**  
18 **SUBSTANTIALY FROM WHEN YOU INITIALLY PREPARED YOU**  
19 **COST OF CAPITAL ANALYSIS IN THE FIRST QUARTER OF 2008?**  
20

21  
22 A. Yes. My initial estimate of the current MRP was 8.9 percent. It is now over 20  
23 percent. Again, this is not surprising. Since the first quarter of 2008 there has  
24 been significant turmoil in the economy and the financial markets creating  
25 significant uncertainty. Uncertainty is risk. Because of this uncertainty, investors

1 require higher returns.

2 **B. Use of Gas Utilities to Develop Cost of Equity**

3 **Q. DO THE MARKET BETAS FOR THE GAS AND WATER UTILITIES**  
4 **CONTINUE TO BE SIGNIFICANTLY DIFFERENT INDICATING THAT**  
5 **GAS UTILITIES ARE LESS RISKY THAN WATER UTILITIES?**

6 A. Yes. Based on recent Value Line data (April 9, 2009), Mr. Rigsby's sample water  
7 companies have an average beta of .82 while his sample gas companies have an  
8 average beta of .62. By relying on gas utilities, Mr. Rigsby makes the error in  
9 assuming that a typical gas utility has the same investment risk as a typical water  
10 utility. Based on the recent data and following an analysis similar to the one I  
11 used in my rebuttal,<sup>8</sup> a minimum of 119 basis point upward adjustment to his gas  
12 utility sample results would be necessary to make his water sample and gas sample  
13 comparable at the present time.

14 **Q. PLEASE EXPLAIN.**

15 A. Using the updated betas for the water and gas sample utilities, and using Mr.  
16 Rigsby's CAPM inputs, the following results would be obtained:  
17

18

<u>RUCO Water Sample CAPM</u>	<u>Rf</u>		<u>Beta</u>		<u>Rp</u>		<u>K</u>
Geometric Mean MRP	1.6%	+	0.82	X	5.1%	=	5.78%
Arithmetic Mean MRP	1.6%	+	0..82	X	6.8%	=	<u>7.18%</u>
<b>Average Water Utility Sample</b>							<u>6.48%</u>

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<sup>8</sup> See Rebuttal Testimony of Thomas J. Bourassa ("Bourassa Rb") at 7

<u>RUCO Gas Sample CAPM</u>	<u>Rf</u>		<u>Beta</u>		<u>Rp</u>		<u>K</u>
Geometric Mean MRP	1.6%	+	0.62	X	5.1%	=	4.76%
Arithmetic Mean MRP	1.6%	+	0..62	X	6.8%	=	<u>5.82%</u>
<b>Average Gas Utility Sample</b>							<u>5.29%</u>

The average of the CAPM estimates for the water companies and gas companies are 6.48 percent and 5.29 percent, respectively. This is a 119 basis point difference.

If my method and inputs are used instead, similar to the method used in the Arizona Water Eastern Group case mentioned in my rebuttal testimony,<sup>9</sup> the result is 2.88 basis points, calculated as follows:

<u>Water Sample CAPM</u>	<u>Rf</u>		<u>Beta</u>		<u>Rp</u>		<u>K</u>
Historical MRP CAPM	2.3%	+	0.82	X	7.5%	=	8.45%
Current MRP CAPM	3.7%	+	0..82	X	21.3%	=	<u>21.17%</u>
<b>Average Water Utility Sample</b>							<u>14.81%</u>
<u>Gas Sample CAPM</u>	<u>Rf</u>		<u>Beta</u>		<u>Rp</u>		<u>K</u>
Geometric Mean MRP	2.3%	+	0.62	X	7.5%	=	6.95%
Arithmetic Mean MRP	3.7%	+	0..62	X	21.3%	=	<u>16.91%</u>
<b>Average Gas Utility Sample</b>							<u>11.93%</u>
<b>Average Water Utility Sample</b>							14.81%
<b>Average Gas Utility Sample</b>							<u>11.93%</u>
<b>Difference/Risk Adjustment</b>							<u>2.88%</u>

<sup>9</sup> Bourassa Rb at 6.

1  
2 **Q. THE BETAS FOR BOTH THE WATER AND GAS COMPANIES ARE**  
3 **LOWER BASED ON MORE RECENT DATA, DOES THIS MEAN THEY**  
4 **ARE LESS RISKY COMPARED TO THE MARKET AS A WHOLE?**

5  
6 A. Yes. Investments in water and gas utilities currently have less market risk. I do  
7 not necessarily disagree with Mr. Rigsby's testimony on pages 9-11 that utility  
8 stocks are more "safe" investments than many other equities at this time. But this  
9 does not mean that the cost of equity for utilities is as low as Mr. Rigsby portrays.  
10 According to the CAPM, investment risk is relative to the market. If MRP's are  
11 high because of current economic and market conditions, then the cost of equity is  
12 high, all things being equal. Utilities may be more "safe", but "safe" is a relative  
13 term.  
14

15 **Q. DOES THAT CONCLUDE YOUR TESTIMONY?**

16 A. Yes, although I do wish to note that my silence on any position taken by Staff or  
17 RUCO, or with respect to any public comment, does not signal agreement.  
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